QUESTIONS AND ANSWERS ON UNIVERSAL SERVICE CONTRIBUTION REFORM AND THE COSUS PROPOSAL

Why is a change in the universal service contribution mechanism needed?

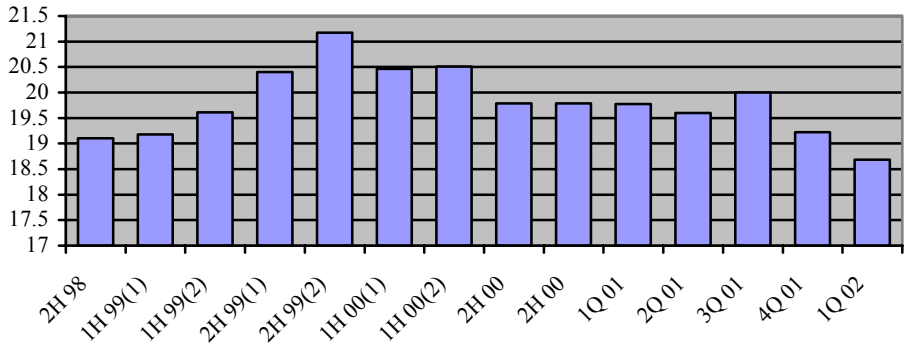
The current universal service assessment mechanism suffers from four basic flaws that make it unsustainable:

- A shrinking base of end user interstate and international telecommunications revenues.
- Inability to address bundled products coherently and in a stable manner.
- Discrimination due to data reporting lags.
- Discrimination due to "safe harbors" (such as for wireless), exemptions (pure play international) and different regulatory schemes.

What is the evidence of a shrinking contribution base?

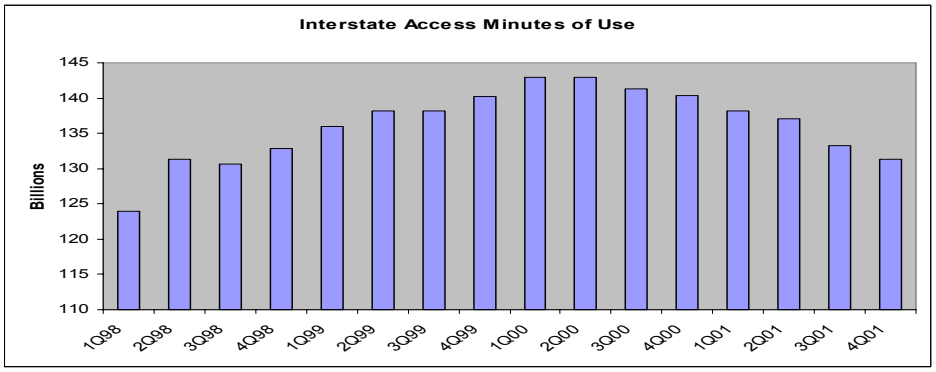
The Commission's own data show that the universal service revenue base of end user interstate and international telecommunications revenues is shrinking:

FCC-Reported
End User Interstate and International
Telecommunications Revenues, 1998-2002



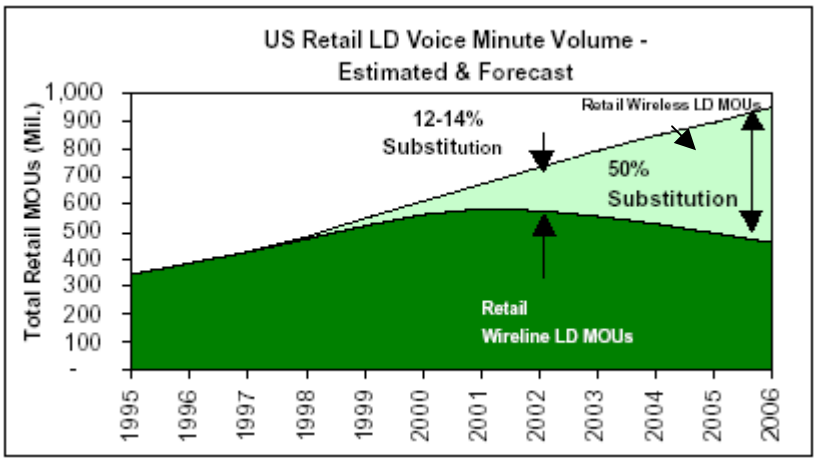
Source: FCC Universal Service Contribution Public Notices; FCC, Telecommunications Industry Revenues: 2000; Universal Service Administrative Co., Federal Universal Service Support Mechanisms Quarterly Contribution Base for the Third Quarter 2002 (filed May 31, 2002).

This is confirmed by the fact that NECA-reported switched access minutes for all ILECs have been declining during this same period:



Source: FCC, "Trends in Telephone Service," Table 11.3, at 11-5 (Aug. 2001); NECA, "March 2002 Supplemental Report of Access Minutes."

A major contributor (but not the only contributor) to this decline has been the growth of wireless long distance services. Because the wireless safe harbor only assigns 15% of wireless revenue to interstate telecommunications, a wireless interstate LD minute of use contributes much less to universal service than wireline long distance service because of the wireless "safe harbor." One analyst has illustrated the effect of wireless substitution on wireline LD as follows:



Source: Sanford C. Bernstein & Co. LLC, "Global Telecom Services Crossroads or Crisis?" at 11(June 6, 2002).

Why can't the current revenue-based system handle bundled products?

The short answer is because there is no set formula to allocate revenues in a bundle between intrastate and interstate telecommunications, and between telecommunications services and other services and products such as information services and CPE. It is not possible to create such a formula without imposing detailed, market-distorting regulations.

Carriers other than ILECs, and ILECs that have pricing flexibility for end user charges, do not set prices according to formulas that strictly define how much revenue will be collected in interstate as opposed to intrastate or non-regulated rates. Carriers can shift charges among interstate, intrastate, and non-regulated services within a bundle to reduce universal service contributions. This reality led Qwest to conclude, "short of the draconian measure of imposing a jurisdictional separations regime on all providers to identify interstate revenues, it is not possible to devise a competitively neutral revenue-based contribution methodology."

How is the current system discriminatory?

The current system discriminates in at least two ways. First, by assessing universal service on revenues received six months earlier, the system systematically and predictably penalizes carriers that have a shrinking market share and rewards those that have growing market shares. If a carrier's assessable revenues are shrinking over time, its current contribution (calculated on the basis of prior period revenues) is a larger share of current revenues larger than for a carrier whose revenues are growing over time.

Second, the wireless "safe harbor" and the pure play international exemption are not competitively neutral. For example, if a customer who makes 100 minutes of wireline long distance calls at 7.5 cents per minute shifts all 100 minutes to wireless, and uses that $7.50 to buy 100 more minutes on a wireless plan (also 7.5 cents per minute), the assessable interstate end user telecommunications revenue for those 100 minutes falls from $7.50 to $1.13 – a decline of 85%. Of course, if the customer simply uses 100 minutes on that customer's existing wireless plan, the assessable interstate end user telecommunications revenue falls by $7.50. Either way, this places the wireline long distance carrier at a substantial competitive disadvantage stemming from the universal service contribution mechanism.

Why can't the current revenue-based contribution system be fixed?

No proposals to modify the revenue-based contribution mechanism address all its problems. Even if the Commission were to take all actions suggested by proponents of a revenue-based contribution mechanism, i.e., expand the revenue base to include internet access, eliminate the wireless safe harbor, and move to a "collect and remit" revenue assessment, it would still not create an assessment mechanism that can coherently and in a stable manner allocate revenues among the different parts of a service bundle. This is because revenue can be shifted among any offerings not subject to strict price regulation in order to minimize universal service contributions. As bundled offerings and all distance offerings continue to grow, no universal service assessment mechanism will be stable unless it can sustainably operate with respect to bundled offerings. The only proposals that sustainably work with bundled offerings are connection-based proposals.

How does the CoSUS Proposal create a more sustainable basis for universal service contribution?

The CoSUS Proposal is more sustainable because it focuses universal service assessment on the one element that every user of interstate public networks must have – a connection to the interstate public networks. These connections – including wireline and wireless – have continued to grow even as interstate revenue has fallen. Moreover, as more paths are created for users to connect to public networks, the contribution base will continue to expand. By focusing on connections, the CoSUS proposal reflects the fact that the network as a whole becomes more valuable to all users as the number of connections to the network increases.

Is the CoSUS Proposal competitively neutral?

Unlike the current system and all other connection-based proposals, the basic structure of the CoSUS Proposal is competitively neutral and treats competing technologies and providers the same. The CoSUS Proposal eliminates discrimination that plagues the current system as a result of the lag between the assessment period and the billing period, the wireless "safe harbors" and the partial international exemption. Competing providers of local connections (whether wireline or wireless) are treated the same under the CoSUS proposal, as are competing providers of long distance service (again whether wireline or wireless). While there are some minor issues with respect to some non-subscription service arrangements that need to be addressed, there should be workable solutions to these issues.

The CoSUS proposal does not discriminate in favor of long distance service providers. To the extent these providers provide end user connections (which they often do for special access and private line services) they will contribute to universal service. To the extent they do not provide to end users their connections to a public network, they are not treated differently than any other carrier, such as a carrier's carrier, that also does not provide to end users their connections to a public network.

Doesn't the CoSUS Proposal dramatically shift USF contributions from long distance carriers to other carriers, and essentially give the long distance carriers a "free ride"?

The CoSUS Proposal will reduce the proportion of universal service contributions from historical long distance carriers, but there is no "free ride." Companies that provide long distance services will still have to contribute to universal service on the basis of all connections they provide. Historical long distance carriers today provide many end user connections, including the rapidly growing number of special access and private line connections, many of which are purchased from an ILEC and then resold. In addition, carriers such as AT&T and WorldCom are also increasing the number of switched local service lines they provide. With the continued rise of bundled packages, and as Bell

Companies enter long distance and historical long distance companies continue their entry into local markets, any differential between what carriers would have paid under a revenues-based system and what they would pay under the CoSUS proposal will continue to narrow. Under the CoSUS Proposal, however, universal service will be collected in a more sustainable, efficient and competitively neutral manner.

Under the CoSUS proposal, there will be a few carriers that provide no end user connections that will no longer contribute to universal service because they do not provide a sufficient number of connections to pass the de minimis threshold, just as there are carriers' carriers that do not contribute to universal service today under the existing formula.

Why doesn't the CoSUS Proposal also assess interstate transmission connections, as SBC and BellSouth have proposed?

The CoSUS Proposal does not assess interstate transmission "connections" in addition to interstate network connections, as SBC and BellSouth have proposed, because assessing transmission connections as well as network connections is functionally duplicative and will incur large, unnecessary transaction costs. The CoSUS proposal minimizes those transaction costs, thereby minimizing the costs that carriers will seek to recover from their customers. All assessments associated with service provided to a customer over a given connection are paid by that customer, regardless of whether the assessment is paid first by the network connection provider alone, or by the network connection provider and the interstate transmission provider.

The result of the SBC-BellSouth proposal is that, for example, the residential consumer with only one telephone line and dial-up internet access service would be billed by three different service providers for universal service recovery charges. Only if that residential consumer takes the residential connection, interstate long distance and dial-up internet access from the same provider is it possible they she might get only one bill covering all universal service recovery fees. Moreover, except in the bundled local/long distance/internet access scenario, multiple carriers will incur the costs of gathering the data necessary to compute the connection assessments paid for serving that customer, billing that customer a universal service recovery charge, and collecting that recovery charge. This results in substantially greater administrative transaction costs than under the CoSUS proposal, and creates an artificial competitive advantage in favor of carriers that can provide the connection, the long distance, and the internet access service as a bundled package.

In addition, because long distance carriers and ISPs do not, in the ordinary course of business, have access to information such as whether the customer is a Lifeline subscriber, or the nature or capacity of the connection used to reach the ILEC's public network, long distance carriers and ISPs would have to acquire this information from the connection provider, usually the ILEC. When long distance carriers have had to do this to implement the Presubscribed Interexchange Carrier Charges (PICCs), the cost of

obtaining, maintaining and updating the data was high. Usually data had to be purchased from the ILECs, which would be an additional cost that long distance carriers would seek to recover from consumers. Moreover, PICCs were implemented only for the price cap LECs. In order to implement the SBC-BellSouth proposal, long distance carriers and ISPs would need to obtain data from each of the 1300 rate-of-return carriers, and these carriers would have to develop the systems necessary to support electronic data exchange of this information. This would further add to the costs carriers and service providers of all types would seek to recover.

The lesson of the Commission's PICC experiment is clear. Consumers end up paying more when the Commission adopts indirect mechanisms that increase transaction costs, in lieu of direct mechanisms that minimize transaction costs. The SBC-BellSouth proposal replicates this mistake, rather than learning from it.

It is also not at all clear how the SBC-BellSouth proposal would operate with respect to new offerings, such as from wireless carriers, that combine voice telecommunications, with e-mail and other information services. This would appear to require three connection assessments (one for the access connection, one for interstate voice service, and one for interstate packet service).

Why doesn't the CoSUS Proposal include assessments on broadband connection providers?

The CoSUS proposal was designed to address the question of how should assessments be collected, not which end user connections should be assessed. The debate over whether broadband connections should be assessed is occurring in a separate FCC docket. The CoSUS proposal can accommodate either outcome of that proceeding, and is not structurally biased in favor or against any resolution of the Commission's *Broadband Internet Access Framework NPRM*.

Doesn't the CoSUS Proposal violate Section 254(d)'s direction that "every telecommunications carrier" providing interstate telecommunications services contribute to universal service?

No. Section 254(d)'s requirements must be read as a coherent and cohesive whole, not as a collage of phrases at war with one another. Section 254(d) requires the Commission to collect universal service contributions from every telecommunications carrier on a basis that is equitable and nondiscriminatory, and that is part of a specific, predictable and sufficient mechanism to support universal service, unless its contributions would be de minimis. The CoSUS Proposal is "equitable and nondiscriminatory" and creates a "specific, predictable, and sufficient" mechanism. Under that connection-based proposal, "every telecommunications carrier" contributes except those that provide so few connections that their "contribution…would be de minimis." It therefore meets every requirement of the provision.

Some have argued that the equitable and nondiscriminatory basis for universal service contribution must generate a contribution from every carrier with more than a de minimis amount of interstate telecommunications revenue. This argument goes beyond the plain text of the statute. The word "revenue" appears nowhere in Section 254(d).

Doesn't the CoSUS Proposal violate the Fifth Circuit's holding in *Texas Office of Public Utility Counsel v. FCC* that Section 2(b) precludes the FCC from assessing intrastate services for universal service contributions?

No. A per connection universal service assessment based on interstate connections does not assess intrastate services. The D.C. Circuit's decision in *NARUC v. FCC*, 737 F.2d 1095, 1113-14 (D.C. Cir. 1984), is directly on point. In that decision, the D.C. Circuit held that the FCC's creation and imposition of per line recovery of interstate, non-traffic sensitive costs did not violate Section 2(b) because the line was, in part, interstate. Under the CoSUS proposal, the only connections assessed are interstate connections, so a fixed assessment per interstate connection does not violate Section 2(b). Unlike the universal service contribution mechanism struck down in *Texas Office of Public Utility Counsel v. FCC*, 183 F.3d 393 (5th Cir. 1999), a carrier's universal service obligation will not increase as its wholly intrastate revenues increase (e.g. increases in intrastate toll revenues do not increase universal service contributions, as they did when the FCC expressly assessed intrastate revenues).

Won't the CoSUS Proposal be more regressive than the current system?

No. At the end of the day, consumers pay the bills of local carriers, long distance carriers, wireless carriers, and ISPs. WorldCom projected the total USF recovery fees that would be paid by consumers within different income brackets, from very low income (less than $15,000 per year) to very high income (greater than $75,000 per year), under the CoSUS proposal. When compared with the current system, total USF recovery fees for residential consumers will be lower on average across all income brackets under the CoSUS proposal than under the current mechanism. This is because low income consumers use long distance services, some quite substantially. The SBC-BellSouth proposal, on the other hand, would be more regressive than the current mechanism.

It is true that some consumers will pay a little more in total USF recovery fees under the CoSUS Proposal than they are paying today, just as others will be paying less. Under the CoSUS Proposal, low income consumers that subscribe to Lifeline pay no USF recovery fees for their Lifeline connection. Concerns about the impact on other low income consumers that are not Lifeline subscribers are better addressed in the first instance by encouraging those consumers to subscribe to Lifeline than by altering an efficient universal service contribution mechanism. It also needs to be recognized that the CoSUS Proposal will reduce the stress that high long distance bills place on low income consumers by reducing the USF recovery fees assessed on high volume, low income consumers. Studies have long shown that these high volume, low income consumers are the most vulnerable to losing their universal telephone service.

Doesn't the CoSUS Proposal benefit large business users, to the detriment of residential consumers?

No. On average, across all income groups, residential consumers will pay less total USF recovery fees to all their service providers than they would under the current systems. All users, however, benefit from the universal service mechanism becoming more efficient and sustainable. All users, especially residential users, will be worse off if universal service support is not sustainable.

The CoSUS Proposal is the only connection-based proposal that actually proposes to charge lower assessments on residential and single line business connections than on multiline business, special access and private line connections. That concession by CoSUS was intended to ameliorate concerns that a connection-based proposal might be regressive. Indeed, the CoSUS proposal is not regressive. However, there is no evidence in the record (or elsewhere) that the CoSUS proposal, or even higher levels of per residential per connection assessment fees, would cause residential customers to lose service. In fact, the CoSUS Proposal will most likely improve subscribership by reducing the bills of those consumers most likely to lose service – low income, high volume toll users.

How quickly can the CoSUS plan be implemented, and what are the implementation costs?

The CoSUS proposal can be implemented quickly, and, for switched connections, with minimal systems changes. All ILECs, for example, already have a universal service recovery fee on their bills. All that would be necessary for these carriers to implement the CoSUS proposal for switched connections would be for these carriers to change the amount of the recovery fee from their current fee to the appropriate new recovery fee. This is no different than rate changes these carriers make today when contribution factors change.

For private line and special access connections, all carriers will need to undertake greater systems development, so that they can report and bill for connections according to capacity. This will require some investment by carriers in their information technology systems. The CoSUS proposal provides a one year transition to allow the time for such systems development to occur. This systems development is necessary for any connection-based contribution mechanism scaled by capacity, not just the CoSUS proposal.